BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION
WASHINGTON, D.C. 20554

In the Matter of	)	
	)	
Access Charge Reform	)	CC Docket No. 96-262
	)	
Price Cap Performance Review for Local Exchange Carriers	)	CC Docket No. 94-1
	)	
Low Volume Long Distance Users	)	CC Docket No. 99-249
	)	
Federal-State Joint Board On Universal Service	)	CC Docket No. 96-45

COMMENTS OF
TEXAS OFFICE OF PUBLIC UTILITY COUNSEL
CONSUMER FEDERATION OF AMERICA
CONSUMERS UNION
(JOINT CONSUMER COMMENTORS)

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The CALLS Proposal Radically Restructures Federal Rates

The FCC should reject the proposal from a coalition[1] (Coalition for Affordable Local and Long Distance Service, "CALLS") – made up entirely of telecommunications companies – to radically alter the recovery of telecommunications costs in the federal jurisdiction.

The CALLS proposal would double the cap on the subscriber line charge (SLC) for primary lines. The industry estimates that the net increase in bottom-of-the-bill charges would be about $1.50 per month for primary residential lines. In addition, it would shift the Primary Interexchange Carrier Charge (PICC) and the Universal Service Fund (USF) from the carriers to consumers.

The proposal would also eliminate the Carrier Common Line Charge (CCL), by using the productivity factor to reduce that charge over time. As soon as the CCL is eliminated, the productivity factor would be eliminated and no further reductions in federal access charges would result from increasing productivity in the industry. The LECs would, however, be able to automatically increase rates to reflect inflation.

In addition, the proposal would settle an audit of the local exchange companies (LECs) which found billions of dollars of irregularities. Unfortunately for the consumer, the proposal does not impose any penalties, set rates at lower levels to reflect past overcharges, or lower rates to reflect phantom assets that are still embedded in the prices charged to consumers. In effect, the CALLS proposal wipes the slate clean.

The CALLS Proposal Will Harm The Majority Of Residential Consumers

The industry defends the CALLS proposal as "a form of social compact between the regulators and all market participants"[2] that "balances the public interests defined by the 1996 Act."[3] In truth the proposal is much more like the famous Washington D.C. tax game – "don't tax you, don't tax me, tax the guy behind the tree." In this case, the guy behind the tree is the typical American residential consumer whose long distance bill will go up as a result of the proposal when it should be going down.

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[1] *Universal Service and Access Reform Proposal*, Coalition for Affordable Local and Long-Distance Service. For purposes of these comments, we refer to the rate proposal itself as the Proposal. We refer to the justification offered as CALLS.

[2] CALLS, p. 35.

[3] CALLS, p. 24.

The net effect of the CALLS proposal would be to give the long distance companies a free ride on the distribution plant of the local exchange carriers. The long distance companies would not pay for the facilities (loop plant) they use to provide the services that they sell to the public.

The CALLS proposal would increase the bottom-of-the-bill charges paid by residential consumers by about $2 billion and institutionalize another $2 billion in long distance company charges as line items sanctioned by the Federal Communications Commission. If the CALLS proposal is implemented, it would magnify the total Federal bottom-of-the-bill charges paid directly by consumers to local exchange companies to about $12 billion in the residential market alone. Of that total, over $7 billion will have been added to the bottom-of-the-bill charges after the passage of the 1996 Act. We do not think that this is what Congress had in mind as a balance of interests.

Studies claiming that all consumers will benefit from the CALLS proposal, such as the study paid for by CALLS but issued under the name of the Alliance for Public Technology (APT),[4] are incorrect because they are based on assumptions that are contradicted by pricing behavior in the industry.[5] The APT study assumes that long distance companies will pass through reductions in costs on a uniform per minute basis. The industry has not done so in the past nor does it commit to do so in the CALLS proposal. <u>The proposal does not even give a guarantee that all of the reductions in access charges will be passed through to consumers, not to mention a commitment to pass them through in a manner that ensures low-volume users will receive a fair share of any reductions.</u> The signatories agree only to "commit to meet with the FCC to review the effects."[6] Simply put, the APT study assumes that there is no price discrimination against low to average volume residential long distance consumers, when, in fact, price discrimination has been brutal.

Ironically, even if one assumes a uniform pass through, the APT analysis shows that about 85 percent of the so-called consumer benefit goes to businesses and upper income households. However, because price discrimination has been rampant in the long distance industry, the outcome will be much worse than that for the majority of consumers.

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[4] Pociash, Stephen B., *An Assessment of Consumer Welfare Effects of the CALLS Plan* (Joel Popkin and Company, October 25, 1999), p. 1, explains the interrelationship between APT, CALLS and the study.

[5] Joint Consumer Commentors have demonstrated that similarly unrealistic assumptions apply to several other recently released industry studies, particularly those by AT&T. *See* Reply Comments, Federal Communications Commission, <u>Notice of Inquiry</u>, Low-volume Long Distance Users, CC Docket No. 99-249 (October 20, 1999).

[6] Proposal, section 6.

The 70 million residential accounts with long distance usage below the mean are likely to suffer a $1 billion net increase in their long distance bills rather than a decrease because of the industry practice of price discrimination. The FCC's own Synthesis Proxy Cost Model, which it has recently applied to deliver increased payments to the large local exchange companies, indicates that these same households should be receiving a net reduction in the federal recovery of costs of at least $1.5 billion, not an increase.

The CALLS Proposal Should Be Rejected

The recommended increases in the subscriber line charge, the elimination of the PICC and CCL and the transformation of the universal service fund into line items are illegal, arbitrary and capricious, uneconomic and unfair.

Illegal:

- The uncompensated use of facilities violates section 254 (k) of the Telecommunications Act of 1996 by allowing IXCs to use shared facilities without paying for them. It is contrary to the long standing interpretation of the requirements for reasonable recovery of shared costs which stretches back 70 years to Smith v. Illinois.

- The CALLS proposal undermines the ability of the Commission to ensure that rates are just and reasonable by "settling" the audit dispute without rate reductions and by eliminating the productivity factors which would force rates to reflect declining costs in the future, while at the same time the proposal includes a mechanism for automatic rate increases.

- The proposal removes the obligation of telecommunications carriers to contribute to universal service, which contradicts the plain language of the Telecommunications Act of 1996.

Arbitrary and capricious:

- The CALLS proposal claims to set switching at forward-looking economic costs. The Commission has recently used forward-looking economic costs to establish the high cost payments for large LECs. Yet, the CALLS proposal does not set recovery of loop costs at forward looking economic levels. In fact, it increases rates even farther above the forward looking economic levels as determined by the very same model used to estimate switching costs and high cost loop costs.

- It is arbitrary and capricious to lower switching costs to reflect forward looking economic costs but raise loop rates, when the very same model indicates they should be reduced.

Uneconomic:

- The CALLS proposal ignores the integrated nature of modern telecommunications plant and the business plans of telecommunications companies to sell bundled local, long distance, and Internet services.

- The proposal would institutionalize federal charges for access that are far in excess of the economic cost of providing access as estimated by the Commission's own forward looking cost model and thereby insulate the charges from competitive pressures.

Unfair:

- The proposal shifts the burden of interstate cost recovery onto the shoulders of low-volume users and fails to ensure that bottom-of-the-bill line item increases will be offset in any reasonable way by long distance usage rate reductions.

- The CALLS proposal indemnifies the companies against future inflation by establishing a mechanism to increase rates, while foregoing future productivity offsets, which could lower rates.

The conclusion we draw from the legal, conceptual and empirical analysis is straightforward – the CALLS proposal should be rejected. Economic analysis demonstrates that the subscriber line charge is too high; public policy dictates that it should be reduced. In a world of efficient, multi-product telecommunications companies, claims that current fixed charges do not cover the federal share of loop costs are contradicted by the FCC's own cost analysis. Increases in unavoidable end-user charges, mandated by FCC action and tolerated by FCC inaction, run directly contrary to the congressional intention that basic service should bear no more than a reasonable share of joint and common costs.

The CALLS Proposal Does Not Provide A Basis For Negotiating Access Charge Reform And Universal Service Implementation

The CALLS proposal has been presented to the Commission as a "take it or leave it" proposition, with a recommendation that the Commission sidestep the consultative process with the Joint Board. This is an offer the Commission can easily refuse. Given the private, industry-only negotiations that gave birth to the proposal, its all or nothing nature, and the effort to avoid the joint federal-state process that Congress required, the proposal should not even be considered as a starting point for discussion.

Instead of increasing the average consumer's bill, as the CALLS proposal would, the FCC should start with the implementation of its forward looking economic cost model that would reduce the recovery of costs from residential consumers. The Joint Consumer Commentors have repeatedly and consistently argued that this would create adequate "head room" to reform access charges and rationalize universal service.

I. INTRODUCTION

A. JOINT COMMENTORS

The Texas Office of Public Utility Counsel (Texas OPC) is the state consumer agency designated by law to represent residential and small business consumer interests of Texas. The agency represents over 8 million residential customers and advocates consumer interests before Texas and Federal regulatory agencies as well as State and Federal courts.

The Consumer Federation of America (CFA) is the nation's largest consumer advocacy group, founded in 1968. Composed of over 250 state and local affiliates representing consumer, senior citizen, low-income, labor, farm, public power, and cooperative organizations, CFA's purpose is to represent consumer interests before the Congress and the federal agencies and to assist its state and local members in their activities in their local jurisdictions.

Consumers Union is a nonprofit membership organization chartered in 1936 under the laws of the State of New York to provide consumers with information, education and counsel about goods, services, health, and personal finance; and to initiate and cooperate with individual and group efforts to maintain and enhance the quality of life for consumers. Consumer's Union's income is solely derived from sale of *Consumer Reports*, its other publications and from noncommercial contributions, grants and fees.

These three organizations (hereafter. Joint Consumer Commentors) have participated in each of the dockets cited in the caption to this Notice of Proposed Rulemaking.[7] The notice is in response to a proposal from a coalition (Coalition for Affordable Local and Long Distance Service, "CALLS") made up entirely of telecommunications companies. It would radically alter the Commission's approach to access charges and harm the majority of residential consumers.[8]

B. THE CALLS PROPOSAL RADICALLY RESTRUCTURES FEDERAL RATES

1. A Sharp Increase in Bottom-of-the-Bill Charges

The CALLS proposal would double the cap on the subscriber line charge (SLC) for primary lines. The industry estimates that the net increase in bottom of the bill charges would be about $1.50 per month. In addition to the net increase, the proposal would shift the Primary Interexchange Carrier Charge (PICC) from the carriers to consumers. It would institutionalize the universal service fund payments as a line item on the bottom of the bill.

The proposal would also eliminate the Carrier Common Line Charge (CCL), by using the productivity factor to reduce that charge over time. As soon as the CCL is eliminated, the productivity factor would be eliminated and no further reductions in federal access charges would result from increasing productivity in the industry. The LECs, however, would be able to automatically increase rates to reflect inflation.

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[7] Federal Communications Commission, Notice of Proposed Rulemaking, Access Charge Reform, CC Docket No. 96-262, Price Cap Performance Review for local Exchange Carriers, CC Docket No. 94-1, Low Volume Long Distance Users, CC Docket No. 99-249 In the Matter of Federal-State Joint Board on Universal Service:, CC Docket No. 96-45 (September 15, 1999).

[8] *Universal Service and Access Reform Proposal*, Coalition for Affordable Local and Long-Distance Service. For purposes of these comments, we refer to the rate proposal itself and Proposal. We refer to the justification offered as CALLS.

The proposal would "settle" an audit of the local exchange companies (LECs) which found billions of dollars of irregularities. Unfortunately for consumers, the proposal would not impose any penalties or lower rates to reflect phantom assets that are still embedded in the prices charged to consumers, or even set the rates at lower levels to reflect the overcharges. The CALLS proposal wipes the slate clean.

2. The CALLS Proposal will harm the Majority of Residential Consumers

CALLS's proponents defend the proposal as "a form of social compact between the regulators and all market participants"[9] that "balances the public interests defined by the 1996 Act."[10] In truth the proposal is much more like the famous Washington D.C. tax game – "don't tax you, don't tax me, tax the guy behind the tree." In this case, the guy behind the tree is the typical American residential consumer whose long distance bill will go up as a result of the proposal when it should be going down.

The net effect of the CALLS proposal would be to give the long distance companies a free ride on the distribution plant of the local exchange carriers. The long distance companies would not pay for the facilities (loop plant) they use to provide the services that they sell to the public.

The CALLS proposal would increase the bottom-of-the-bill charges paid by residential consumers by about $2 billion and institutionalize another $2 billion in long distance company charges into line items sanctioned by the Federal Communications Commission (FCC or the

[9] CALLS, p. 35.

[10] CALLS, p. 24.

Commission). If the CALLS proposal is implemented, it would increase Federal bottom-of-the-bill charges paid directly by consumers to local exchange companies to about $12 billion in the residential market alone. This result is tantamount to a federal tax that is largely insulated from competitive pressures. Of this total, over $7 billion will have been added since the passage of the Telecommunications Act of 1996. We do not think this is the balance that Congress had in mind.

Studies claiming that all consumers will benefit from the CALLS proposal, such as the study paid for by CALLS but issued under the name of the Alliance for Public Technology (APT),[11] are incorrect because they are based on assumptions that are contradicted by pricing behavior in the industry.[12] The APT study assumes that long distance companies will pass through reductions in costs on a uniform per minute basis. The industry has not done so in the past nor does it commit to do so in the CALLS proposal. <u>The proposal does not even give a guarantee that all of the reductions in access charges will be passed through to consumers, not to mention a commitment to pass them through in a manner that ensures low volume users will receive a fair share of any reductions.</u> The CALLS signatories agree only to "commit to meet with the FCC to review the effects."[13] Simply put, the APT study assumes that there is no price discrimination against low- to average-volume residential long distance consumers, when, in fact, price discrimination has been brutal.

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[11] Pociash, Stephen B., *An Assessment of Consumer Welfare Effects of the CALLS Plan* (Joel Popkin and Company, October 25, 1999), p. 1, explains the interrelationship between APT, CALLS and the study.

[12] Joint Consumer Commentors have demonstrated that similarly unrealistic assumptions apply to several other recently released industry studies, particularly those by AT&T; *see* Joint Consumers Reply Comments, Federal Communications Commission, <u>Notice of Inquiry</u>, Low Volume Long Distance Users, CC Docket No. 99-249 (October 20, 1999).

[13] Proposal, section 6.

Ironically, even if one assumes a uniform pass through, the APT analysis shows that over 85 percent of the so-called consumer benefit goes to businesses and upper income households. Because price discrimination has been rampant in the long distance industry, the actual outcome will be much worse for the majority of consumers.

The 70 million residential accounts with usage below the mean are likely to suffer a $1 billion net increase in their long distance bills rather than a decrease because of the industry practice of price discrimination. The FCC's own Synthesis Proxy Cost Model, which it has recently applied to deliver increased high-cost payments to the large local exchange companies, indicates that these same households should be receiving a net reduction in the federal recovery of costs on the order of $1.5 billion.

3. The CALLS Proposal should be Rejected

The recommended increases in the subscriber line charge, the elimination of the PICC and CCL and the increase in, and transformation of, the universal service fund into a line item are illegal, arbitrary and capricious, uneconomic and unfair.

Illegal:

- The uncompensated use of facilities violates section 254 (k) of the Telecommunications Act of 1996 by allowing IXCs to use shared facilities without paying for them. It is contrary to the long standing interpretation of the requirements for reasonable recovery of shared costs which stretches back 70 years to Smith v. Illinois.

- The CALLS proposal undermines the Commission's ability to ensure that rates are just and reasonable by "settling" the audit dispute without rate reductions and by eliminating the productivity factors which would force rates to reflect declining costs in the future. At the same time, the proposal includes a mechanism for automatic rate increases.

- The proposal removes the obligation of telecommunications carriers to contribute to universal service, which contradicts the plain language of the Telecommunications Act of 1996 (the Telecommunications Act or the 1996 Act).

Arbitrary and capricious:

- The CALLS proposal claims to set switching at forward-looking economic costs. The Commission has recently used forward-looking economic costs to establish the high cost payments for large LECs. Yet, the CALLS proposal does not set recovery of loop costs at forward looking economic levels. In fact, it increases rates well above the forward-looking economic levels, as determined by the very same model used to estimate costs of switching and high-cost loops.

- It is arbitrary and capricious to lower switching costs to reflect forward-looking economic costs but raise loop rates, when the very same model indicates they should be reduced.

Uneconomic:

- The CALLS proposal ignores the integrated nature of modern telecommunications plant and the business plans of telecommunications companies to sell bundled local, long distance, and Internet services.

- The proposal would institutionalize federal charges for access that are far in excess of the economic cost of providing access as estimated by the Commission's own forward-looking cost model and would insulate a huge revenue stream from competitive pressures.

Unfair:

- The proposal shifts the burden of interstate cost recovery onto the shoulders of low-volume users.

- It indemnifies the companies against future inflation by establishing a mechanism to increase rates, while foregoing future productivity offsets, which could lower rates.

- It fails to ensure that bottom-of-the-bill line item increases will be offset in any reasonable way by long distance usage rate reductions.

The conclusion we draw from the legal, conceptual and empirical analysis is straightforward – the CALLS proposal should be rejected. Economic analysis demonstrates that the subscriber line charge is too high; public policy dictates that it should be reduced. In a world of efficient, multi-product telecommunications companies, claims that current fixed charges do not cover the federal share of loop costs are contradicted by the FCC's own cost analysis. Increases in unavoidable end-user charges, mandated by FCC action and tolerated by FCC inaction, run directly contrary to the congressional intention that basic service should bear no more than a reasonable share of joint and common costs.

4. The CALLS Proposal does not Provide a Basis for Negotiating Access Charge Reform and Universal Service Implementation

The CALLS proposal has been presented to the Commission as a "take it or leave it" proposition, with a recommendation that the Commission sidestep the consultative process with the Joint Board. This is an offer the Commission can easily refuse. Given the private, industry-only negotiations that gave birth to the proposal, its all or nothing nature, and the effort to avoid the joint federal-state process that Congress required, the proposal should not even be considered a starting point for discussion.

Instead of increasing the average consumer's bill, as the CALLS proposal would, the FCC should start with the implementation of its forward-looking economic cost model that would reduce the recovery of costs from residential consumers. The Joint Consumer Commentors have repeatedly and consistently argued that this would create adequate "head room" to reform access and rationalize universal service.

C. OUTLINE OF THE COMMENTS

The remainder of these comments is organized as follows. We will first examine the fundamental economic question of the nature of loop costs. We then consider the implications of basing federal cost recovery on forward-looking economic costs, as CALLS proposes for switching and the Commission has recently done for the large LEC high-cost fund. Next we examine several other elements in the CALLS proposal that call its legality into question. Finally, we consider the equity issues and the impact on low-volume consumers.

II. THE ECONOMIC AND LEGAL NATURE OF LOOP COSTS

A. SHARING OF COSTS BETWEEN SERVICES THAT USE JOINT AND COMMON FACILITIES ACROSS JURISDICTIONS REMAINS SOUND ECONOMIC AND PUBLIC POLICY.

Conceptual definitions of costs, analysis of the historic patterns of investment and current, real world activity all indicate that the distribution plant is a shared facility whose costs should be recovered from all services that use it.

1. Conceptual Definitions of Cost

Joint Commentors have consistently argued that the loop is a common cost for all telecommunications services that utilize it. In our universal service comments we made the following observations:

> The loop is a telecommunications facility used to complete all telephone calls -- local, intraLATA long distance, and interLATA long distance. It is also used to provide enhanced services. It is impossible to complete an interLATA long distance call without a loop. When the loop is in use to complete an interLATA long distance call, it cannot be used to complete another call.[14]

In its Local Competition comments, Texas OPC defined these costs as follows:

> Joint cost: Costs incurred in the provision of two or more services, that are not captured in the incremental costs of each service individually when the services are produced in fixed proportions
>
> Common cost: Costs, incurred in the provision of two or more services, that are not captured in the incremental costs of each service individually when the services can be produced in variable proportions.
>
> Shared cost: Generic terms for costs that are shared between two or more services that are not captured in the incremental costs of each service individually.[15]

The Commission has adopted a cost and pricing methodology that recognizes the fundamental economics of the modern telecommunications network. This approach involves (1) the recognition of the telecommunications network as a multi-product undertaking exhibiting strong economies of scale and scope; (2) the treatment of the loop as a common cost; and (3) the

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[14] "Initial Comments of the Texas Office of Public Utility Counsel," In the Matter of Federal-State Joint Board on Universal Service, CC Docket No. 96-45, April 12, 1996, p. 6.

[15] Initial Comments of the Texas Office of Public Utility Counsel," In the Matter of Implementation of Local Competition Provisions in the Telecommunications Act of 1996, CC Docket No. 96-98, May 16, 1996, pp. 21-22.

comprehension of competitive market behavior. The economic evidence that the telecommunications network is a multi-product enterprise enjoying economies of scale and scope is overwhelming.

- On the supply-side all long distance calls use the network exactly the same way local calls do. Vertical services (like Call Waiting, Call Forwarding and Caller ID) are supported by all parts of the network. Basic service accounts for about one-quarter of total revenues generated per line because the line is shared by an ever-increasing array of services.

- The demands on shared facilities are likely to accelerate as advanced services begin to share in the use of these facilities.

- On the demand-side, customers expect to receive long distance service when they order telephone service. Vertical services are strong complements of basic service. If a provider sells basic service to a customer, competitors are very unlikely to sell that customer Call Waiting.

- Companies are eager to sell local service and long distance service bundled together.[16] One-stop shopping is an integral part of providers' business plans. In such a bundle, why is local cost the "cost causer", as the LECs and IXCs claim?

A reasonable basis to determine the allocation of shared costs is to analyze the facilities and functionalities necessary and actually used in the production of goods and services. In order to produce a long distance call IXCs need distribution plant, as well as switching plant and transport plant. Instead of basing economic analysis on a guess about what consumers really wanted when they purchased a bundle of services, the Commission should rely on a "service pays" principle. That is, services that use facilities should be considered to benefit from the deployment of those facilities and every service that uses a facility should help pay for it.

[16] Providers are also intensely interested in bundling many more services, such as Internet and data services, in addition to local and long-distance calling.

2. Historic Patterns of Investment Reveal the Fallacy of Attributing Loop Costs to only Basic Local Service

Historical analysis of why telecommunications investments were actually made shows that most telecommunications technologies were deployed for and used by business customers first. Hence, it is more reasonable to assume that those customers caused the investment. History shows that the integration of the long distance network into the local network (they actually started as two separate networks) raised the cost of the integrated network. Since the integrated network costs more as a result of the addition of long distance, it is reasonable to assume that long distance causes costs in the integrated network. In other words, complaints that business customers and long distance users pay too much actually ignore the historic pattern of cost causation.

Now that the companies are intensely competing to sell bundles of services, the fiction that local service causes the loop cost should be put to rest once and for all. In truth, since the first decade of this century, the network, including the loop, has been consciously designed to serve local and long distance. Long distance was not an afterthought; it was always a forethought, included in the design, development and deployment of the network. Vertical services have been included in economic analyses of network design and architecture for over a decade.

Although historical analysis demonstrates the fallacy of attributing loop costs to only basic local service, it is clear that efforts to unravel the network into cost causation categories are difficult. For that reason, the analysis of costs should be based on the only footing on which sensible economic analysis can be launched -- an assessment of the product, not the psychology of the customer. Regulators should analyze the facilities and functionalities necessary and actually used in the production of goods and services. They should rely on a service pays principle. That is, services that use facilities should be considered to cause the deployment of those facilities. Assumptions about prime movers are arbitrary. There should be no free rides; every service that uses a facility should be required to share in the recovery of the cost of that facility on a reasonable basis.

- As a matter of economics, costs for joint and common facilities should be recovered on the basis of the nature and quality of use that each service makes of those facilities.

- As a matter of public policy from a universal service docket perspective, recovery of joint and common costs should be structured in such a way as to promote universal service by keeping basic service affordable. Adding line items to the bottom of the bill or increasing them makes connectivity to the network more expense and less affordable.

3. Real World Pricing Behavior

Although some theoretical economists chafe at the thought of recovering shared costs across a range of products, common sense and real world experience demonstrates that this is the way markets work. For example, one of the Regional Bell Operating Companies made this argument in the federal universal service proceeding.

> The Telecommunications Act of 1996 does not require the Commission to replace any, or all, of the contributions to joint and common costs in the interstate access charge system with universal service funding...

They do not require the Commission to eliminate all, or even a major portion, of the contributions to joint and common costs in the interstate access charge system with a universal service funding mechanism, if those contributions do not preserve or advance universal service...

As a practical matter, the Commission must construe Section 254 in this way because it is neither possible, nor desirable, to create a rate structure for telecommunications services that reflects the true economic cost of serving each customer. The costs of service for a particular customer vary by the type of facilities provided, the customers' location, the volume of service, the short run and/or long run effect on capital deployment, and a host of other factors that change constantly. For this reason, a carrier defines a class of customers and develops averaged rates for the entire class. Even if the carrier disaggregates its rates by geography, time of day, or volume, the rate level is the same for the group of customers in the disaggregated category. This means that some customers in the category will pay more than the cost of the service, and the excess revenues from these customers subsidize other customers that are paying rates that do not recover their costs. Moreover, marketing considerations often dictate that rates for some services will directly subsidize rates for other services. For instance, supermarkets do not charge customers for parking, but recover the cost of parking in the price for groceries. They do this because it is a more effective way of encouraging customers to shop...

Thus, even in a perfectly competitive market, variable amounts of contribution to joint and common costs, and cross-subsidies between services, will always exist. Such pricing practices are not inconsistent with Section 254 unless they represent direct subsidies for universal service. [17]

In a similar proceeding in Texas, one of the potential competitors also made the point that a common sense understanding of economic behavior requires the recovery of costs across all services that share facilities.

In response to comments filed by MCI, Sprint and SWBT, TCG reiterates its strong support of the Commission's recommendation to calculate the subsidy requirements as the difference between total revenue per line and the forward-looking cost of those services rather than the difference between basic service rates and the cost of basic service. Such an approach is simply common sense and

[17] "NYNEX Comments," before the Federal Communications Commission, In the Matter Of Federal-State Joint Board on Universal Service, CC Docket No. 96-45, April 12, 1996, pp. 3, 4, 5.

recognizes the fact that telephone subscribers buy much more than basic service and generate far more revenue for their local service provider than the rates for basic service and the subscriber line charge. Indeed, to the extent that rates for basic service do not cover the cost of basic service (forward-looking or otherwise), the shortfall may be more than overcome by profits from discretionary services. The basic service rates, therefore, are no more than a loss leader for the provider, used to attract the customer so that the provider can sell him other, more profitable products and services.

It is also important to realize that discretionary services (e.g., call forwarding, call waiting, call answering) and access to a long-distance provider can be provided to that customer only by the customer's basic service provider. That is, once a customer selects a local service provider, that provider captures the *exclusive* right to sell that customer additional services. The Commission has correctly recognized, therefore, that subscribers to basic service are much more valuable to their carriers than the rates for basic service would imply, and that such revenue opportunities should be taken into account when calculating the support requirement.

Including such revenue in the benchmark both prevents a windfall from accruing to the ILECs and allows the marketplace to establish cost-based rates for all services including access. The windfall is prevented because a higher benchmark produces a smaller universal service fund, adjusted automatically for the revenue from access and vertical services. Cost-based rates will result from competition among local service providers for the entire package of services. It is important to realize that the telecommunications industry is extremely dynamic and costs will continue to decline. Competition will only accelerate this trend of declining cost reducing the need for universal service support. Moreover, because a competitive marketplace is the only real guarantor of cost-based prices, there is no need for the commission to intervene to "guess" at what costs ought to be.[18]

Moreover, the SLC and other fixed charges make no sense in a competitive market when competitors sell bundled local, toll, and long distance service. The fictions that the FCC has established among these "classes" of service will no longer be relevant and will be unable to exist in a competitive market where the line has been blurred between jurisdictional offerings.

[18] "Reply Comments of Teleport Communications Houston, Inc. and TCG Dallas Concerning Proposed Rules on Universal Service Fund Issues," before the Public Utility Commission of Texas, Investigation of Universal Service Issues, Project No. 14929, October 10, 1997.

Competitors will not be selling "local" service or "long distance"; they are and will be selling a bundled package of telephony along with cable, data and Internet services.

B. LEGAL PRINCIPLES

1. Federal and State Law

The Telecommunications Act of 1996 certainly understood the economics of the industry and sought efficient entry across a broad range of services.

- The Act promotes the deployment of advanced telecommunications services and information technologies and insists on a sharing of joint and common costs.
- The Act repeatedly recognizes that advanced services and basic service are linked.
- The Act recognizes that competitive and non-competitive services will be commingled on the network and its purpose is to advance this multi-product network.

The law directly addresses the revenue responsibility of these various services. The cross-subsidy and joint cost language of 47 USC 254 (k) addresses this point.

> Subsidy of Competitive Service Prohibited – A telecommunications carrier may not use services that are not competitive to subsidize services that are subject to competition. The Commission, with respect to interstate services, and the States, with respect to intrastate services, shall establish any necessary cost allocation rules, accounting safeguards, and guidelines to ensure that services included in the definition of universal service bear no more than a reasonable share of the joint and common costs of facilities used to provide those services.

This policy recognizes two distinct steps that are necessary to have fair and efficient pricing in an emerging, partially competitive environment -- a strict prohibition on below cost pricing and a reasonable recovery of joint and common costs across services that share facilities. The Conference Report states this principle more vigorously. The Conference Committee Report clarifies the standard for cost allocation by adopting the Senate report language --

> The Commission and the states are required to establish any necessary cost allocation rules, accounting safeguards, and other guidelines *to ensure that universal service bears no more than a reasonable share (and may bear less than a reasonable share)* of the joint and common facilities used to provide both competitive and noncompetitive services. [19]

In pursuit of universal basic service, this language establishes a reasonable share of joint and common costs allocated to basic service as an *upper* limit.

The FCC, the states, and the courts have found consistently and repeatedly that the loop is a common cost. The courts recognized this almost three quarters of a century ago in Smith v. Illinois.[20] Many of the states have formally recognized this in comments in federal proceedings,[21] and in their own cost dockets.[22]

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[19] Conference Report, p. 129, *emphasis added.*

[20] 282 U.S. 133 (1930).

[21] Two of the Regional Bell Operating Companies take this point of view (Bell Atlantic and NYNEX), as do a number of state regulators: the Texas Public Utility Commission, the Nebraska Public Service Commission, the New Hampshire Public Utilities Commission, the New Mexico State Corporation Commission, the Utah Public Service Commission, the Vermont Department of Public Service and Public Service Board, and the Public Service Commission of West Virginia. In the Matter of Federal-State Joint Board on Universal Service, Before the Federal Communications Commission, FCC 96-93, CC Docket No. 96-45, April 12, 1996 p. 18; "Comments of the State of Maine Public Utility Commission, the State of Montana Public Service Commission". Virtually all other Consumer Advocate commentors share this view in their initial comments. "Comments of the Idaho Public Service Commission" In the Matter of Federal-State Joint Board on Universal Service, Before the Federal Communications Commission, FCC 96-93, CC Docket No. 96-45, April 12, 1996, p. 17; "Comments of the Public Utility Commission of Texas" In the Matter of Federal-State Joint Board on Universal Service, Before the Federal Communications Commission, FCC 96-93, CC Docket No. 96-45, April 12, 1996, p. ii; "Initial Comments of the Pennsylvania Public Utility Commission to the Notice of Proposed Rulemaking and Order Establishing Joint Board" In the Matter of Federal-State Joint Board on Universal Service, Before the Federal Communications Commission, FCC 96-93, CC Docket No. 96-45, April 12, 1996, p. 7.; Florida, p. 22; "Initial Comments of the Virginia Corporation Commission," In the Matter of Federal-State Joint Board on Universal Service, Before the Federal Communications Commission, FCC 96-93, CC Docket No. 96-45, April 12, 1996, p. 5; "Comments of the Staff of the Indiana Utility Regulatory

The failure to take legitimate joint and common costs into account would frustrate the purposes of the 1996 Act. Allowing incumbents to recover joint and common costs excessively from fixed charges on the bottom of the bill discourages efficiency and frustrates competition by allowing incumbents to price more competitive services at an artificially low level. Contrary to the basic premise of the 1996 Act, allowing incumbents to recover an unreasonable share of joint and common costs from basic service insulates incumbents unfairly from market forces.

In the residential sector alone, the CALLS proposal would transform over ten billion dollars of the cost of distribution facilities into a bottom-of-the-bill mandated federal payment to local exchange companies. Once these costs appear on the bottom of the bill, they tend to

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Commission" In the Matter of Federal-State Joint Board on Universal Service, Before the Federal Communications Commission, FCC 96-93, CC Docket No. 96-45, April 12, 1996, p. 9.

[22] "Report of Glenn P. Richardson, Senior Hearing Examiner, Application of GTE South Incorporated For Revisions to Its Local Exchange, Access and IntraLATA Long Distance Rates, Commonwealth of Virginia State Corporation Commission, Case No. PUVC950019, March 14, 1997, p. 84; Application of the Mountain States Telephone and Telegraph Company dong Business as U.S. West Communications, Inc., for Approval of a Five-Year Plan for Rate and Service Regulation and for a Share Earnings Program, Colorado Public Utilities Commission, Docket Nos. 90a-665T, 96A-281T, 96S-257T, Decision No. C97-88, January 5, 1997, pp. 42-43; Decision and Order Rejecting Tariff Revisions, Washington Utilities and Transportation Commission v. U.S. West Communications Inc., Docket No. UT-950200, April 11, 1996 pp. 83-84; Department of Utility Controls' Investigation Into the Southern New England Telephone Company's Cost of Providing Service, Department of Public Utility Control, Docket No. 94-10-01, June 15, 1995, pp. 24-25; Report and Order, In Re: US West Communications, Inc., Utah Public Service Commission, Docket No. 95-049-05, November 6, 1995, p. 95; Final Decision and Order, In Re US West Communications Inc., Iowa Utilities Board, Docket No. RPU-95-10, May 17, 1996, p. 295, 306; Final Decision and Order, In Re US West Communications Inc., Iowa Utilities Board, Docket No. RPU-94-1, November 21, 1994; In the Matter of the Application of GTE Southwest Incorporates and Contel of the West, Incorporated to Restructure Their Respective Rates, New Mexico State Corporation Commission, Docket NO. 94-291-TC, Phase II, December 27, 1995, pp. 11, 14-15; New England Telephone Generic Rate Structure Investigation, New Hampshire Public Utilities Commission, March 11, 1991, DR 89010, slip, op., pp. 39-40; Order No. 18598, Re: Investigation into Nontraffic-Sensitive Cost Recovery, Florida Public Service Commission, 1987; Docket No. 860984-TP, pp. 258, 265-266; Order No. U-15955, Ex Parte South Central Bell Telephone Company, Docket No. 1-00940035, Louisiana Public Service Commission, September 5, 1995, p. 12; In Re Formal Investigation to Examine and Establish Updated Universal Service Principles and Policies for Telecommunications Services in the Commonwealth, Docket No. 1-00940035, September 5, 1995, p. 12; In the Matter of a Summary Investigation into IntraLATA Toll Access Compensation for Local Exchange Carriers Providing Telephone Services Within the State of Minnesota, Minnesota Public utilities Commission, Docket No. P-999/CI-85-582, November 2, 1987, p. 33.

become institutionalized and are much less likely to be competed away. These line items become a floor that the industry starts with, rather than a cost to be attacked by competition.

2. The FCC's Conceptual Paradigm for Cost Recovery

In a series of recent rulings to implement the 1996 Telecom Act, the FCC has constructed a comprehensive paradigm that starts from the fundamentally correct premise that the loop is a shared cost. There should be no doubt that this is the correct treatment of loop costs and alternatives should be clearly and loudly rejected.

The FCC began in the local competition docket by recognizing that the loop is a shared cost of local, long distance and the other services that use the loop. As discussed above, separate telecommunications services are typically provided over shared network facilities, the cost of which may be joint or common with respect to some services.

> The costs of local loops and their associated line cards in local switches, for example, are common with respect to interstate access service and local exchange service, because once these facilities are installed to provide one service they are able to provide the other at no additional cost.[23]

The FCC followed that decision with its proposed rulemaking on access charge reform, in which it reaffirmed the observation that the loop is a common cost.

> For example, interstate access is typically provided using the same loops and line cards that are used to provide local service. The costs of these elements are, therefore, common to the provision of both local and long distance service.[24]

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[23] Federal Communications Commission, First Report and Order: Implementation of the Local Competition Provisions of the Telecommunications Act of 1996, CC Docket No. 96-98, ¶678.

[24] Federal Communications Commission, In the Matter of Access Charge Reform, Price Cap Performance Review for Local Exchange Carriers, Transport Rate Structure and Pricing, End User Common Line Charges: Notice of Proposed Rulemaking, CC Docket Nos. 96-262, 94-1, 91-213, 95-72, ¶ 237.

The FCC applied this conclusion in its decision to convert the Common Carrier Line (CCL) charge into a flat rate charge to cover loop costs.

> We reject claims that a flat-rated, per line recovery mechanism assessed on IXCs would be inconsistent with section 254 (b) that requires equitable and nondiscriminatory contribution to universal service by all telecommunications providers. The PICC is not a universal service mechanism, but rather a flat-rated charge that recovers local loop costs in a cost causative manner.[25]

In the reform of the separations process, the FCC has stated the economic reasoning and analysis which underpins this treatment of the loop.

> Nearly all ILEC facilities and operations are used for multiple services. Some portion of costs nonetheless can be attributed to individual services in a manner reflecting cost causation. This is possible when one service, using capacity that would otherwise be used by another service, requires the construction of greater capacity, making capacity cost *incremental* to the service. The service therefore bears a causal responsibility for part of the cost. The cost of some components in local switches, for example, is incremental (i.e. sensitive) to the levels of local and toll traffic engaging the switch. Most ILEC costs, however, cannot be attributed to individual services in this manner because in the case of joint and common costs, cost causation alone does not yield a unique allocation of such costs across those services. The primary reason is that shared facilities and operations are usually capable of providing at least one additional service at no additional cost. In such instances, the cost is *common* to the services. For example, the cost of a residential loop used to provide traditional telephony services usually is common to local, intrastate toll, and interstate toll services. In a typical residence, none of these services individually bears causal responsibility for loop costs because no service places sufficient demands on capacity to warrant installation of a second loop. Another reason why a relationship may not exist between cost and individual services is that some shared facilities or operations provide services in fixed proportion to each other, making the cost *joint* with respect to the services. ILEC billing costs, for example, tend to be joint with respect to local,

[25] Federal Communications Commission, In the Matter of Access Charge Reform, Price Cap Performance Review for Local Exchange Carriers, Transport Rate Structure and Pricing, End User Common Line Charges: First Report and Order, CC Docket Nos. 96-262, 94-1, 91-213, 95-72, ¶ 104.

> state toll, and interstate toll services. For the majority of bills rendered, billed charges always include all three services. The fixed combination of services makes it impossible for one service to bear responsibility for billing costs...
>
> Both incremental cost and stand-alone cost (which are usually expressed per unit of output) are greatly affected by the way we choose to define the increment and the service class. The incremental cost of carrying an additional call from residences to end offices, for example, is zero if the residences are already connected to end offices, but the incremental cost of establishing such connections is the cost of the loops. [26]

Moreover, the importance of ensuring the correct loop allocation cannot be overemphasized. As the FCC notes, the proper identification of loop costs is critical to telecommunications pricing because loop costs constitute almost half of all costs of local exchange carriers.[27] For example, ARMIS data indicate that loop plant investment in 1996 was 49% of total plant investment.

Most importantly, the FCC's methodology for estimating costs of basic service for purposes of identifying high cost areas is consistent with its logic of properly allocating loop costs. Two of the ten criteria it establishes for specification of a cost model require similar treatment of joint and common costs:

> (2) Any network functionality or element, such as loop, switching, transport, or signaling, necessary to produce supported services must have an associated cost...

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[26] Federal Communications Commission, In the Matter of Jurisdictional Separations Reform and Referral to the Federal-State Joint Board, Notice of Proposed Rulemaking, CC Docket No. 80-286, November 10, 1997 (hereafter, Separations NPRM), pp. 14-15.

[27] Separations NPRM, p. 16

(7) A reasonable allocation of joint and common costs must be assigned to the cost of supported services. This allocation will ensure that the forward-looking economic cost does not include an unreasonable share of joint and common costs for non-supported services.[28]

Having concluded that the loop is a shared cost, we turn to the question of how the share of those costs that are allocated to uses that fall within the federal jurisdiction should be recovered. The CCL is a charge to cover the use of a joint and common facility, the loop.

If the CCL is transformed into either an increase in the SLC or into a draw on the universal service fund, the long distance companies (IXC) will be getting a free ride on the loop.[29] The IXC would be allowed to use a joint and common facility -- the loop – while passing all of the costs through to consumers as fixed per line charges. Eliminating the CCL clearly violates the policy that services included in universal service bear only a reasonable share of joint and common costs. Given the high levels of usage of interLATA long distance service and the demands placed on the network by these services, the CCL is not too high. Indeed, the interLATA use of the loop may already exceed the percentage of loop costs recovered through the CCL.

[28] FCC, Universal Service Order, ¶ 250.

[29] Notice, ¶ 114, pp. 46-47.